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Successful Joint Ventures Among Farmer Cooperatives

Abstract

Successful Joint Ventures Among Farmer Cooperatives

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This report describes development, purposes, operations, and challenges of four successful joint ventures among dairy cooperatives. Provides guidelines applicable to any cooperative for deciding whether to enter into a joint venture with one or more cooperatives, and how to structure such a venture to maximize the chances of achieving its objectives.

Key words: Cooperatives, efficiency, joint venture, structure

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Preface

Unable to draw on outside investors for equity, cooperatives must make maximum use of member-supplied capital resources. Joint ventures of two or more cooperatives enable farmers to seize business opportunities that might otherwise be beyond their grasp. They can do this by pooling their expertise while limiting the amount of capital tied up and at risk.

This report presents case studies of four successful joint ventures among dairy cooperatives. It offers guidelines, based in large measure on the case studies, for planning and implementing new ventures among all types of cooperatives. Its objective is to aid cooperative leaders willing to share risks and rewards and can help their cooperatives remain successful businesses and increase services and returns to producer members.

This report is based on information gathered from personal interviews of two or more directors and managers of each venture studied, a review of the organizational papers and other documents provided by participants in each venture, and secondary material on the ventures studied, participants in these ventures, and joint ventures in general.

Joint ventures among dairy cooperatives were selected as study subjects for several reasons. Dairy cooperatives have a high level of producer commitment. A number of joint ventures among dairy cooperatives have been operating successfully for some time.

Also, dairy cooperatives are well into a structural consolidation now confronting other types of cooperatives. In fact, the latest mergers among midwestern dairy cooperatives may alter the joint venture status of some of the study subjects. This highlights one of the ways joint ventures can lead to stronger cooperatives, by instilling confidence in leaders of different associations that they can not only cooperate but also consolidate if that will improve services and returns for members.

Specific financial data on joint ventures is considered confidential by some cooperatives. Successful ventures, those providing valuable services and margins to participants over a reasonable period of time, were identified through observations by the Agricultural Cooperative Service (ACS) staff. Study subjects are proven vehicles for enhancing the economic conditions of producers.

Acknowledgments

The author thanks all the cooperative leaders who donated time for interviews and made documents available for review. Thanks also to James Roof, ACS Program Leader for Dairy and Livestock, whose suggestions were of great assistance in the preparation of this report.

Contents

Highlights

A joint venture is a separate entity, owned and controlled by a small number of participants, to carry on a specific, limited economic operation. Participants share on an agreed basis expenses, margins, losses, risks, and control of the arrangement.

The first section of this report consists of case studies of four joint ventures among dairy cooperatives. These detailed summaries provide, by example, information about the development, purposes, operations, and challenges of successful cooperative joint ventures. The second section presents guidelines for all cooperatives contemplating a joint venture, drawn in large part from the experiences of the cooperative participants in the ventures discussed previously.

The ventures are discussed in the order they were established. To the extent feasible, information on the four ventures is presented in the same order in each summary. An introductory paragraph presents the name of the venture, location of the home office, year of origin, structure, plant location, product line, and annual sales.

The subjects are geographically dispersed, one each in New York, Wisconsin, Missouri, and Idaho. All have been in operation for some time, with origin dates from 1959 to 1979. Two of the ventures are cooperative corporations, one is a partnership, and one is a contractual agreement. Each has one or more processing plants. Three of the ventures produce manufactured dairy products; one operates milk bottling facilities. Annual sales range from $13 million to $90 million.

A background section reviews why the venture was initiated, how the site was selected, how the original financing package was structured, and any changes in the makeup of the participants since the venture began.

Each of these ventures began because one or more of the eventual participants was confronted by a problem it was finding difficult to solve on its own. Three ventures involve the operation of facilities already in existence, so location was predetermined; one venture location was selected entirely on the needs of the participants. Sources of original financing included Banks for Cooperatives, industrial revenue bonds, cash reserves of the participants, and plants and equipment provided the venture by

participants. Two ventures have had the same two participants since inception; two ventures have had a number of different participants, and at the time of the study each had three.

The purposes of the ventures are essentially the same, although the emphasis varies. First, the ventures seek to provide a needed service for the participants and their producer-members. Second, they strive to generate additional margins for their participants. As each was begun in response to a problem, their record of generating margins quickly and consistently demonstrates the potential of joint ventures for other cooperatives.

Next, the current operations of each venture are described. Subjects covered include current financial commitments, board composition, staff direction, raw product procurement, marketing responsibility, nonparticipant business, competition, and plans for possible termination.

As these ventures are earning margins, most current financing is internally generated. Participants in two of the ventures share financial obligations and rewards on an equal basis; those in the other two do so on the basis of patronage.

The boards are composed entirely of producer-directors of the participants, or a combination of producer-directors and managers of the participants. In no case were only managers on the venture board. While a majority of the members of the three-participant ventures have the power to decide policy, in fact unanimous agreement among the participants is a prerequisite to major board actions for all the ventures studied.

In two of the ventures, the general manager reports to the board, and in two others reports to the "managing" participant. This is correlated to the responsibility for providing raw materials and marketing. In the first two ventures, all participants provide raw product and the venture staff markets production. In the latter two, one is responsible for providing raw product and the "managing" participant markets production.

All ventures use raw product of nonparticipants from time to time, including that of rival cooperatives. The decision to accept this product is based on financial considerations.

None of the venture agreements limit competition between the participants or between the venture and its participants. Each agreement contains a termination procedure.

Each case study concludes with a look at challenges facing the venture. These fall into two groups. The first involves adjusting to changing markets. As the markets for their primary products mature, the processing ventures are striving to develop new products that can be manufactured in existing facilities and successfully marketed without substantial new investments by the participants.

The second set of challenges are people problems. As the participants are often competitors for producers and in other lines of business, maintaining trust and sharing responsibilities requires constant tact and compromise.

The guidelines section is divided into two subsections, deciding whether to form a venture and structuring a successful venture.

When entering into a joint venture with one or more other cooperatives, each association should:

1. Have the necessary background information, compiled through a feasibility study.
2. Be economically compatible with the other participants.
3. Feel at ease dealing with the other participants.
4. Respect the business performance of other participants.
5. Be sure plants and other physical assets are convenient.
6. Have adequate control over venture policy.
7. Know the venture will not adversely impact other operations.

Implementation of each venture studied was pursuant to a written agreement setting forth how the venture will be operated. Many common subjects, covered in these agreements, should be dealt with in any joint venture agreement among cooperatives, including:

1. legal structure
2. purposes
3. finance
4. distribution of margins
5. control
6. employees
7. raw materials acquisition
8. marketing responsibility
9. nonparticipant business

10. rights to compete
11. structural reorganization
12. amending the agreement

Any other matter where the participants want binding directives established should also be covered in the written agreement.

Joint ventures are appropriate for numerous activities that farmer cooperatives may wish to engage in, including value-added manufacturing, research and development, distribution, and export marketing. They can also be the first step to more extensive cooperation among cooperatives.

Successful Joint Ventures Among Farmer Cooperatives

Donald A. Frederick

Changes in the structure of agriculture, finance, transportation, and public policy are challenging the ability of farm marketing, supply, and service cooperatives to compete in today's business environment. Cooperatives cannot attract equity from outside investors, so they must make the best possible use of member investments and borrowed funds. Joint ventures between cooperatives is one tool available to management to maximize the benefits to members from available assets.

DEFINING A JOINT VENTURE

There is no clearly established, legal definition of a "joint venture." Any collective business conduct, including the formation of a cooperative, involves a joint effort among the participants.

For purposes of this report, a "joint venture" is defined more narrowly. It is a separate entity, owned and controlled by a small number of participants, to carry on a specific, limited economic operation. Participants share on an agreed basis expenses, margins, losses, risks, and control of the arrangement.

The distinguishing feature of this definition is the restriction on the size and purpose of the operation. These ventures assist the participants achieve their objectives, but clearly do not threaten the individual identities or autonomies of the participants.

For clarity, the term "participant" is used in this report to designate a cooperative that is a party to a venture. "Member" refers to a producer-member of a cooperative.

SUCCESSFUL VENTURES

O-AT-KA Milk Products Cooperative, Inc.

O-AT-KA Milk Products Cooperative (O-AT-KA), Batavia, NY, is the oldest joint venture studied. It has been in operation since 1959. O-AT-KA is a corporation, formed under the 1951 Cooperative Corporation Law of New York. It operates two diversified milk balancing plants producing canned evaporated milk, milk powder, and butter. Sales in recent years have averaged about $90 million.

Background

The milk situation in upstate New York in the mid-1950's was characterized by great swings in the price of milk, caused by oversupply during the "flush" months (a period of high production per cow in the spring and early summer). Farmer cooperatives were faced with making drastic pricing concessions or losing milk sales during these periods.

Several small, antiquated milk manufacturing plants were in the area, but they lost money because of production and marketing inefficiencies. Sometimes product had to be dumped for lack of storage, transportation, or buyers.

Feasibility studies by cooperatives in the region indicated a modern, high-volume facility would succeed, one that could balance the market by holding all surplus milk off the market and thus maintain a price floor. It would also have to generate margins by lowering unit costs through economies of scale. While several cooperatives expressed an interest in joint development of such a plant, only Genesee Valley Cooperatives and Western New York Milk Producers Cooperative found the potential rewards justified the necessary initial investment of $1 million.

The studies indicated several criteria for locating the plant. Direct delivery of milk should be possible from both the Buffalo and Rochester areas. Adequate and reasonably priced supplies of water, natural gas, and electricity should be available. And sewer capacity should exist to handle waste water in compliance with environmental


O-AT-KA MILK PRODUCTS

protection laws. A site south of Batavia, NY, was selected because it met these requirements.

A financing plan was developed with the Springfield Bank for Cooperatives. The bank loaned one-half the required funds directly to O-AT-KA. One founding cooperative provided one-sixth of the total capital needed and the other the remaining one-third. This 1:2 split of member capital contribution roughly equaled the ratio of their respective shares of the markets to be served.

Severe weather and other problems delayed completion of the plant for more than a year. One original participant had financed its share of the contribution to capital on a long-term basis and adjusted easily to the delay. The other, which relied on short-term financing from local banks, found its working capital position strained by the delay.

The plant generated margins almost immediately. Its success stimulated a period of growth that made O-AT-KA large enough to be an even more efficient venture. Frontier Federated Cooperative (Frontier), Dairymens League (now Dairylea), and Niagara Milk Cooperative (Niagara) became participants in the 1960's. This provided new capital to pay for modernization and expansion, and additional product to be processed and marketed.

The two original participants merged, and then affiliated with Frontier and other local cooperatives to form Upstate Milk Cooperatives, Inc. (Upstate). This further increased the amount of member milk available to the venture. A second plant at Collins Center was acquired by O-AT-KA from local producers who affiliated with Upstate.

Purposes

The three current participants in O-AT-KA—Upstate, Dairylea, and Niagara—agreed the venture has to serve the same two purposes as when it began operation.

First, it has to balance the market by providing a home for participants' surplus milk. Each of the participants preferred to sell all members' milk in the more lucrative fluid, class I market. However, during the spring flush period and over long weekends (when bottlers

close), it wasn't possible. Also, external factors such as breakdowns, strikes, and adverse weather can disrupt the fluid market at any time. O-AT-KA accepts the surplus milk and manufactures it into products that can be stored and sold.

While not the primary objective, making money has always been a secondary goal of O-AT-KA. If it only broke even, O-AT-KA would benefit producers by providing an alternative when their cooperatives negotiated with a milk buyer. The price floor O-AT-KA provides stabilizes the market to the benefit of all producers whether or not they belong to a cooperative. However, O-AT-KA has returned margins to participants in all but 2 of its 26 years of operation.

Operations

The venture has continued the original policy of using volume in the markets served as the means of determining relative shares of capital contributions. The ratio between the participants is currently about 5:3:1.

While investment is determined by patronage, control is not. Each participant has three seats on the nine-member Board of Directors. O-AT-KA's directors are all experienced farmer-directors of the participants. There is little turnover on the O-AT-KA board, so the directors have accumulated substantial experience in governing the venture.

The bylaws permit any two participants to decide any issue. However, there is an unwritten understanding that no action will be taken unless all participants agree.

Executive responsibility is vested in a general manager selected by the board. The general manager runs the operations and hires and fires other employees.

Employees at the Batavia plant are unionized; those at the Collins Center plant are not. The plant manager handles initial negotiations at Batavia. Contracts are signed by the general manager, after consultation with an executive committee of board members.

O-AT-KA has a unique method of establishing the transfer price it pays participants for milk. Participants contribute 5 cents for each hundredweight of pooled milk produced in the area served by O-AT-KA. This gives O-AT-KA a cushion to compensate it for the uncertainties of when its market balancing capabilities will be needed.

When milk is delivered to O-AT-KA, the supplier is paid the applicable milk market order price plus a premium agreed on by the manager and board. Thus the participants recoup part of the assessment when they patronize the venture. The premium is usually set conservatively, allowing the venture to retain a strong cash flow position and minimize chances of a loss.

Margins have resulted from a number of factors. Management has adjusted to changes in the manufactured milk products market. Facilities have been modernized on a regular basis. The venture has taken full advantage of lower transportation costs from its plant to east coast and Puerto Rican markets than comparable costs for its midwestern competitors. The USDA dairy program has also benefited O-AT-KA.

The venture accepts milk from nonparticipants, including direct competitors of its owners. While O-AT-KA occasionally has the opportunity to charge nonparticipants in need of a home for surplus milk above-market fees, it does not do so. It foregoes the short-term profit to keep harmony in the market and alternative outlets available for its participants when O-AT-KA's facilities are unable to meet all their needs.

No meaningful competition occurs between the venture and the participants. O-AT-KA provides a service the participants accept as their responsibility, but not one they wish to actively engage in on their own.

The bylaws contain a dissolution provision that provides that after all debts have been paid and equity redeemed, any remaining balance will be paid to the participants on an equitable basis as determined by the board.

Challenges

Supply management is a continuing challenge for O-AT-KA. As the acknowledged market of last resort, it takes whatever milk shows up at the receiving station.

Detailed plans guide management in making daily "on the spot" decisions on how to handle arriving supplies. These plans reflect ongoing research into the current desires of commercial marketing outlets for manufactured milk products and the anticipated balancing needs of participants.

O-AT-KA must compete with other dairy manufacturers for raw product. When first organized, O-AT-KA had marketing agreements with its owners. However, the participants found complying with these contracts restricted their marketing flexibility, and they decided to abandon them.

Recently new minimum delivery contracts have been signed by participants with O-AT-KA. The hope is that O-AT-KA, by being able to better plan its production and marketing schedules, will provide a better overall return to producers than they realize if all surplus is placed on a competitive bid basis. Early experience indicates these benefits will be realized.

A second challenge for O-AT-KA is adjusting to changes in the market for manufactured dairy products. The market for O-AT-KA's highest margin product, canned evaporated milk, is declining. This is making it increasingly difficult for the venture to achieve its goals of processing all the milk it receives and generating margins.

The participants agree the future of O-AT-KA will be brighter if it can develop and market new value-added products. However, planning and initiating new programs is costly and time consuming. The participants are striving to accomplish this objective without redirecting resources being used to keep their cooperatives operating as efficiently as possible.

Northland Foods Cooperative

Northland Foods Cooperative (Northland), Shawano, WI, has operated since 1968. The venture is incorporated as a cooperative pursuant to chapter 185 of the Wisconsin statutes. It operates a whey processing plant in Shawano. Sales in recent years have averaged about $13 million.

Background

Whey is that part of milk that separates from the curd during the process of making cheese. For many years, environmental concern was the major reason cheesemakers did not simply dump their whey.

Whey has become a valuable product to the food processing industry. When dried, it has a market as an ingredient in bakery products, frozen foods, and dry mixes. Also, nutrients, protein and lactose (sugar), can be extracted from the whey and sold as separate products.

In the late 1960's, when the market value of whey was expanding, there was only one whey processing plant in Wisconsin. The noncooperative owner of this facility passed on to his whey suppliers only a token amount of the increased profits being generated in the market because of the lack of competition.

Consolidated Badger Cooperative of Shawano* became interested in processing whey as a means of changing a disposal cost into a profit. Consolidated Badger lacked marketing expertise to sell whey, so Land O'Lakes was approached for advice. Discussions and feasibility studies by these two cooperatives led to the formation of Northland.

Shawano was selected as the location for the plant because Consoli-

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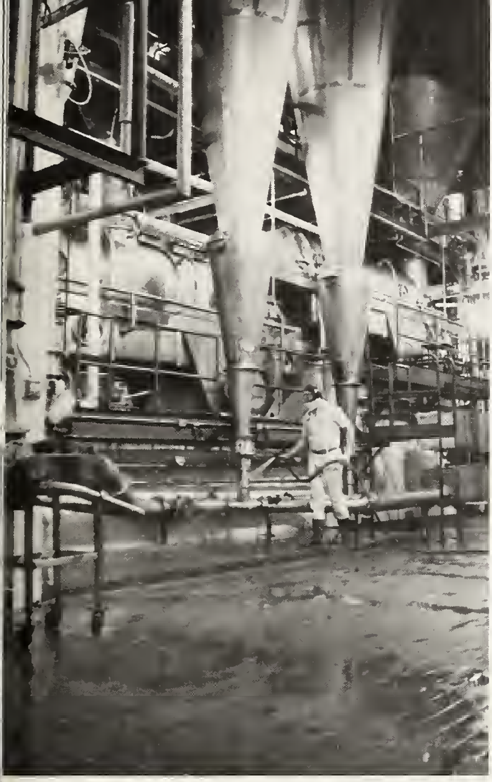
*This association was known as Consolidated Badger during most of the life of the venture. In the spring of 1985, it changed its name to Morning Glory Farms. In the fall of 1986, it merged with the Mid-States Region of Associated Milk Producers, Inc., to form the Morning Glory Farms Region of AMPI. The impact of this merger of the two principal participants on the future structure of Northland is unclear, but it does not diminish the value of studying Northland's past as a model for future joint ventures among cooperatives. In this report, the name at the time of the event under discussion will be used when referring to this cooperative.




Northland Foods
Northland Foods
Northland Foods

dated Badger had an idle drying facility on its property there. Except for this factor, the operation might have been located near Marshfield, 75 miles to the west, a more convenient location to sources of supply.

Consolidated Badger contributed this drying facility as its major initial investment in the venture. Land O'Lakes provided cash to purchase equipment and pay other startup costs.

Greenwood Milk Products joined the venture shortly after it was formed and has remained a participant. In 1974, Associated Milk Producers, Inc. (AMPI) purchased two cheese plants in Wisconsin. It joined Northland and has remained a participant.

Other cooperatives have joined and then withdrawn when they no longer needed a home for their whey.

The venture has been a continuing success, providing a market for participants' whey and usually at least breaking even.

However, almost from the beginning there were differences of opinion between the marketing and production participants. Land O'Lakes was named the exclusive marketing agency for products of Northland. It collected fees from the venture for marketing, and set prices. About 80 percent of the product was used by Land O'Lakes.

As Land O'Lakes grew, it expanded its own whey processing plants. This further increased concerns of other Northland participants over a possible conflict of interest.

In the early 1980's, a management consulting firm was hired to study strategies to improve the position of the venture in the face of growing competition. That firm recommended a restructuring that caused Northland to develop its own sales and marketing program and Land O'Lakes to withdraw from the joint venture.

Purposes

Consolidated Badger originated Northland to better position itself in the expanding whey market. It realized the potential market for dry whey as a food ingredient, but had no strategy to capitalize on the

much broader market that was evolving. Greenwood and AMPI became participants for the same reason, to develop a better market for their whey.

Now that the nutritional value of whey is better understood, the participants hope to develop new products and further increase Northland's potential to generate margins.

Operations

Until the recent Morning Glory-AMPI merger, Northland had three participants - Morning Glory, AMPI, and Greenwood. The venture secured necessary participant equity through a base capital plan, with investment aligned with participant patronage.

Patronage also plays a part in determining control. Each participant names from one to three directors depending on the quantity of whey solids marketed during the preceding fiscal year. Before the merger, two of the participants had two seats on the board; the third had one seat. Both managers and farmers are board members.

The general manager is selected by the board and reports to the directors. He selects and supervises the venture staff. Labor union negotiations are handled by the venture manager, but contracts must be approved by the participants before they can be ratified.

Consolidated Badger made personnel from its marketing staff available to the venture to develop its marketing program. Present participants indicate the development of internal marketing capability eliminated tension between the participants. They seem satisfied with the results, and feel less need to keep a close watch on marketing activities. Board meetings were reduced from once a month to once a quarter.

Participants provide whey to Northland on a no-cost basis. They each have a supply agreement with Northland detailing the approximate amount of whey to be supplied, the locations from which the whey will be delivered, and other matters the board agrees from time to time are necessary.

The venture performs the processing and marketing functions and returns margins to participants on a patronage basis. Earnings from nonparticipant business are allocated to a general reserve fund for use as determined by the board.

The articles of association provide that upon liquidation, after debts and equity are paid, remaining assets will be distributed according to patronage.

Challenges

Two factors are combining to make it difficult for Northland to secure all the whey it wants. One is the increasing recognition of whey's value. As the size of cheese plants in Wisconsin has grown, many have added their own whey processing equipment.

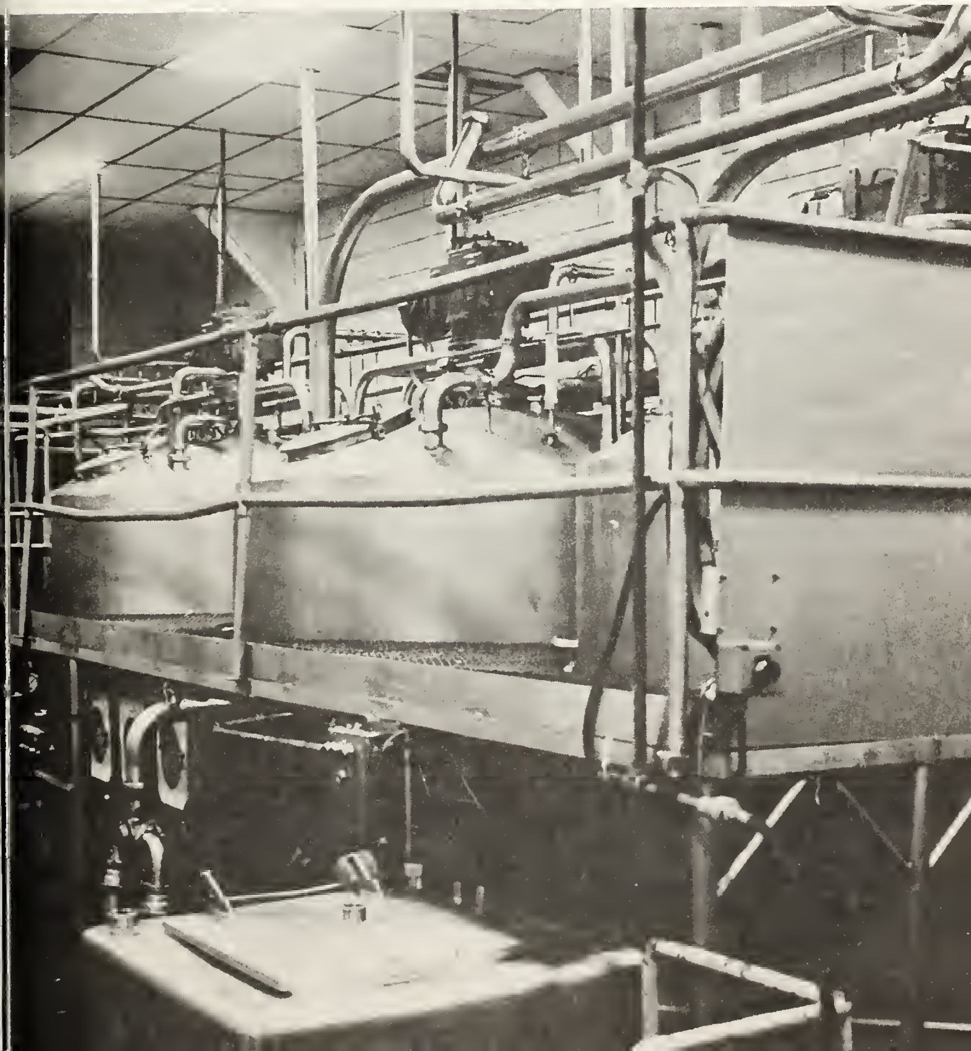
Also, unprocessed whey has become a popular feed for veal producers. Some cooperatives can get a better price for whey from veal producers than from processors.

Second, changes in government policy to reduce milk production threaten to limit growth in cheese production and, thus, production of whey as well.

Northland is exploring opportunities in foreign markets. The relatively high value of the dollar during the mid-1980's made it impossible for prospective overseas customers to pay the price Northland needs to produce requested products at a profit. But work continues to develop specialized whey products for export that will create a valuable niche for the venture.

Western Foods Processing Company

Western Foods Processing Company (Western Foods), Idaho Falls, ID, was organized in 1977. The joint venture is created by a contractual agreement. It operates a dry milk product processing plant in Idaho Falls. Sales have averaged about $15 million in recent years.



Background

In the mid-1970's, Western General Dairies (Western General)* bought a dehydrator, the latest equipment for drying whey. It will also remove the water from a large number of soft agricultural products, including shortening and peanut butter, and turn them into powder. The equipment was located in Idaho Falls across the railroad tracks from a Western General cheese plant.

Western General did not have sufficient marketing expertise in the commodities produced to earn margins on its investment. Mid-America Dairymen, Inc. (Mid-America), was operating the same type of facilities and successfully marketing similar products in the Midwest. A feasibility study by Mid-America indicated an opportunity to market the production of this plant to snack food manufacturers and other food processors on the West Coast. Contracts were finalized and Western Foods was organized.

Western General sold a one-half interest in the plant and equipment to Mid-America, receiving a promissory note and retaining a security interest in the property. This enabled Western General to recover part of its investment in the project. Western General and Mid-America then transferred their respective one-half interests to the joint venture.

Western General borrowed additional funds from the Sacramento Bank for Cooperatives required to launch the venture. Mid-America guaranteed repayment of one-half the amount borrowed.

The operation began generating margins in 1979 and has been consistently profitable since.

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*This association was known as Western General during most of the life of the venture. In the summer of 1984, Western General joined three other cooperatives to form Intermountain Milk Producers. In the fall of 1986, this association merged with another cooperative to form Western Dairymen Cooperative, Inc. The name of the organization in existence at the time of the matter under discussion will be used in referring to these cooperatives.

Purposes

When the venture began, Western General was primarily looking for a way to minimize potential losses from an investment that wasn't working out. Mid-America saw an opportunity to use its marketing expertise to generate additional margins for its producer-members and to produce finished products closer to the west coast markets of some of its customers.

Today, both participants look at the venture primarily to generate margins. If the outlook for profitability does not remain positive, the arrangement will probably be reorganized or terminated.

Operations

The participants have an equal obligation to meet financial needs of the joint venture. Capital requirements have been met with internally generated funds.

Returns and losses are shared equally by the parties to the venture.

Control is vested in a six-member board of advisers (directors) composed of the general manager and two farmer-directors of each participant.

The board has two regularly scheduled meetings a year. One is held in conjunction with the annual meeting of the National Milk Producers Federation. All directors of both organizations are invited to attend this meeting. The second meeting alternates between the home areas of the two participants. This permits directors of each participant to learn about the other, and affords interested producers the opportunity to talk to the policymakers for the venture at least once each year.

An employee of Mid-America serves as overall manager for the venture. The plant manager reports to this individual. The plant manager hires and supervises all other employees of the joint venture. Production employees are unionized. Mid-America handles the labor negotiations.

Mid-America has agreed to make available to the venture, royalty free,

some trade secrets, formulas, patents, and trademarks. Disclosure by anyone connected with the venture is expressly forbidden.

Western General has maintained the books of account and been reimbursed for its accounting services. It also has handled the administrative chores of the payroll.

Both participants have agreed to provide technical assistance, at cost, to the venture as requested by the manager or board of advisors. This includes advice concerning the manufacture, processing, and storage of product.

Western Dairymen has first option to supply the raw material needs of the operation, at prices agreed to by the participants. If Western Dairymen cannot meet those needs, inputs may be secured from nonparticipants.

Mid-America has an exclusive right to market the products produced by the joint venture. Mid-America performed this service "at its cost" until it paid off the promissory note. It then negotiated a marketing fee for the service.

There are no prohibitions to participants competing with the venture.

If either party should decide to withdraw, the joint venture agreement contains a buy-sell procedure designed to maximize the opportunities for the participants to keep control of the assets each wants.

Partnership returns are filed to report financial results and other information needed by the participants in filing their respective tax returns.

Challenges

While Intermountain was pleased with the job Mid-America had done marketing Western Food's production, it was aware of the continued growth of similar operations owned exclusively by Mid-America. Mid-America has several sources of supply to fill its orders for dry product, and Intermountain was becoming concerned Western Food might not always have the fullest opportunity to be competitive with Mid-America's other plants.

Both participants see the need for research and development to be increased, to develop new products. Cooperatives always have a problem financing research and development and implementing it. The participants are studying whether to commit their own funds to such efforts or to have the venture assume more debt should additional capital be needed.

Hiland Dairy Company

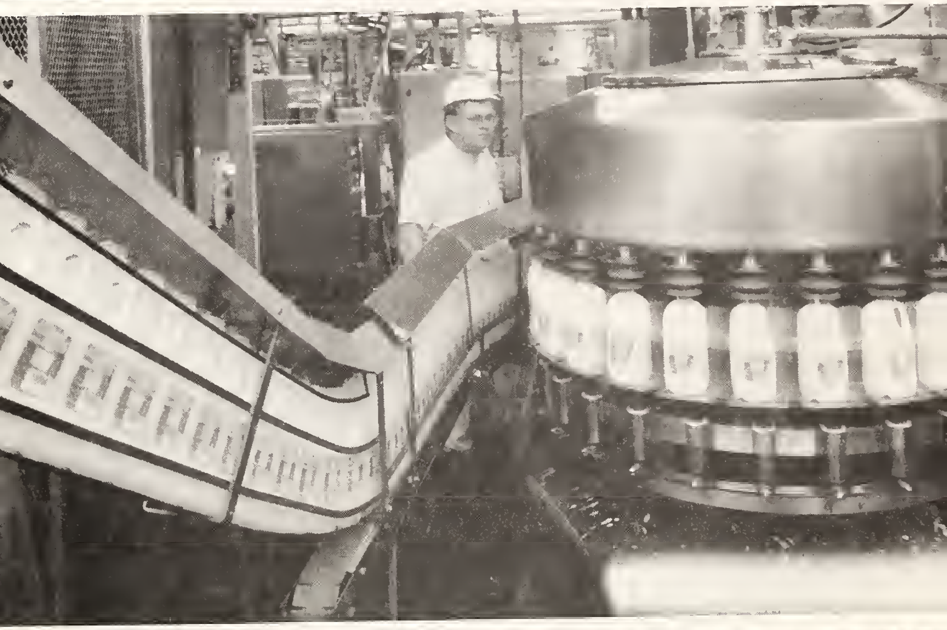
Hiland Dairy Company (Hiland), Springfield, MO, was formed in 1979. It is organized as a partnership under the Uniform Partnership Law of the State of Missouri. It operates a fluid milk bottling plant in Springfield. Sales average about $75 million per year.

Background

In the late 1970's Foremost and Hiland dairies were the only purchasers of fluid milk in the Springfield area. Both were noncooperatives. Hiland was owned by three aging partners. It had labor problems and depressed earnings. The owners announced that if the operation could not be sold as an ongoing business they would close it and liquidate the company.

Mid-America Dairymen, Inc. (Mid-America), which is headquartered in Springfield, was concerned about the loss of competition and a shortage of bottling capacity in its home area if the plant closed. Mid-America could afford to buy the company, but it did not really want to enter the bottling business. It was quite comfortable operating as a marketing association, and did not want to go into direct competition with Foremost, which bought all its milk from Mid-America.

Prairie Farms Dairy, Inc. (Prairie Farms), also had reason to be interested in the situation. It was located just across the Mississippi River from Missouri in Carlinville, IL. It is primarily a bottling cooperative and thought it best Mid-America not become a direct competitor. Also, it had recently entered into a joint venture with Dairymen, Inc., to operate a dairy and was benefiting from that arrangement.



Both cooperatives had grown through acquisition. Both had confidence in the other's ability to negotiate a fair deal. And while they compete for milk, especially in Illinois, both are effectively managed by pragmatists who have not let this competition stand in the way of cooperation when joint action is in the best interest of both.

Finally, Prairie Farms recognized the Mid-America staff had expertise in arranging industrial revenue bond financing. The interest savings available by using this financing instrument to acquire the assets of Hiland acted like a magnet, drawing both cooperatives into the venture. Each participant contributed equally to the cash requirement of the financing package.

Purposes

As with the other ventures reviewed in this report, the participants in the Hiland Dairy purchase were interested in finding avenues for growth and increased return to members. The venture provided nominal returns during its first year of operation. Volume and margins were satisfactory by the second year and have remained at an acceptable level since.

The joint venture arrangement in Hiland enables the participants to expand their expertise and minimize potential increased competition between themselves. Prairie Farms has expertise in managing fluid milk, cultured products, and ice cream plants. Mid-America's expertise lies in its ability to supply large volumes of milk to bottling plants efficiently, handle the seasonal and weekly reserve supplies, and market manufactured dairy products.

Operations

Participants share equally in meeting equity needs of the venture, and in its margins and losses. Required capital has been internally generated and allocated to participants' capital accounts. No interest is paid on these accounts. Funds are loaned to the venture by the participants at the rate of interest they are paying on funds borrowed for their operations.

Control is vested in a six-member committee consisting of two employees and a director of each participant. Meetings are held quarterly, or as needed. Decisions are made by negotiated agreement.

Prairie Farms is the "managing" participant. It makes all determinations affecting the day-to-day operation of the business. It makes decisions on quality, production, and marketing, and keeps the books.

This is an interesting arrangement because Prairie Farms is headquartered hundreds of miles from the plant while Mid-America is just across town. Mid-America employees admit to "looking over the shoulder" of Prairie Farms and sometimes wondering about minor decisions that would not even come to their attention if the plant were not in their town. However, they have not attempted to interfere in day-to-day management decisions and neither party considers the location a problem.

The managing participant directs the plant manager and other management and professional employees. All staff members, including the plant manager, are employees of the venture. As managing participant, Prairie Farms negotiates all employee relations issues, including union contracts.

The partnership agreement specified that the former managing partner of Hiland would be the original plant manager. This eased much of the concern among valued production employees and minimized potential employee problems during the transition to new ownership.

With the consent of Mid-America, Prairie Farms may assign its own employees to the venture instead of hiring additional staff and receive reimbursement for their total aggregate compensation.

Mid-America has the right and responsibility of supplying all the venture's requirements of bulk fluid milk. Mid-America purchases milk from nonmembers, including competing cooperatives, when it makes economic sense to do so. But the sale of the milk to the venture is always from Mid-America.

The agreement contains a provision making it clear participants are free to compete with the venture and each other, except the managing

partner cannot take unfair advantage of its position to the detriment of the venture.

The joint venture agreement contains complex termination provisions generally providing for an equal division of any residual value after specified obligations are met.

Challenges

Some differences of opinion have resulted at Hiland due to the different characteristics of the participants. Mid-America, as a marketing association and the supplier of milk, is interested in establishing the highest price possible for product provided the venture. This not only maximizes the benefit its members realize from their investment in Hiland, but also establishes a price that can be used as a benchmark in negotiations with other customers.

Prairie Farms is also concerned with the farm price of milk. However, as a manufacturing cooperative, it can also generate earnings for members on finished products.

Also, being participants in joint ventures has not affected their status as competitors for milk in southern Illinois, which has recently become a deficit milk production area. New Government policies to further reduce production may heighten this competition.

Finally, Mid-America has entered into other joint ventures with both cooperative and noncooperative processors. Milk from these ventures sometimes competes with milk from Hiland. Prairie Farms is concerned Mid-America may be able to use its influence over bulk milk pricing in various markets to gain undue influence over prices Prairie Farms, as managing participant, can set for the venture.

These four case studies demonstrate how cooperatives can use joint ventures to maximize services and margins provided to producer-members. However, the mere formation of a joint venture among cooperatives is no more a guarantee of success than the organization of a cooperative by farmers. Careful planning is crucial.

The next section of the report draws on the experiences of the ventures discussed above to identify issues and suggest how they should be addressed when contemplating and structuring a joint venture among cooperatives.

GUIDELINES

Once a cooperative recognizes a problem or an opportunity, several courses of action are usually available. Management must decide the most appropriate response to the situation. This section of the report focuses on matters with special significance when a joint venture with one or more other cooperatives appears to be a viable option.

There is no "magic formula" for structuring a successful joint venture. Each must be tailored to meet the individual objectives and available resources of the participants. But there are common issues to be considered, both in deciding whether to attempt a joint venture and in defining how each will operate. How effectively the participants deal with these issues will be a major factor in determining a venture's degree of success.

Attempting a Joint Venture

When formulating the ventures discussed above, each of the eventual participants was able to provide an affirmative answer to several key questions. Regardless of the motivation for forming a venture, each potential participant should be able to answer "yes" to these questions.

• Will a joint venture meet our objectives? Ascertaining the appropriate facts is essential to an informed decision on whether to initiate a joint venture. A feasibility study is very useful in compiling this information. The study should include data and appropriate analysis on the services the venture will provide; projected costs, output, markets, revenues, and margins; capital requirements, both equity and debt; inventory turnover; and plant, equipment, and staffing requirements.

The study can be conducted internally by one or more of the potential participants, or requested from State and/or Federal agencies (such as

the Extension Service or Agricultural Cooperative Service), universities, commodity organizations, or private consulting firms. The source is not important so long as the information is thoroughly developed and presented in a manner that can be understood by the managers and directors of potential participants.

If the feasibility study produces promising forecasts, then potential participants should ponder a number of more subjective matters. Some may have been touched in the study. All bear on whether the proper chemistry is likely to develop between the participants.

• Are our operations compatible? Each of the participants and each of the ventures studied is in the same general business. Each cooperative participant understands how the venture ought to operate and can assess its success internally on a continuous basis. When decisions need to be made, policymakers can sit down around a table and communicate effectively as they all understand the matter under consideration.

This does not mean the participants need to be mirror images, or even share all the same objectives. The founders of O-AT-KA all made similar contributions to solve a common problem. The initial participants in Northland, Western, and Hiland brought different but complementary skills, assets, and aspirations to their ventures. What is important is that the combination of participants resulted in a cohesive unit with all components necessary for success available to the venture.

• Do we feel at ease when dealing with the other potential participants? At the time of inception, each participant in these ventures respected and trusted management of the other participants. Enough challenges arise naturally from dealing with other cooperatives, even under the best of circumstances. Compromise is often essential to resolving problems. A venture may well be destined to fail if the participants can't work out problems in a reasonable amount of time.

Of course, agriculture is a dynamic industry. Differences can develop between participants that make it difficult to handle problems easily

disposed of in earlier times. Then they must be able to reassess their arrangement and make changes to restore compatibility.

• Do other potential participants have an established track record? All participants in these ventures were proven successes as dairy marketing associations before the ventures began. They had member loyalty, an adequate financial base, and an experienced core of able leaders. They had shown they could set realistic goals and achieve them.

A new cooperative, a cooperative with a new management team, or a new entrant into the general line of business may need a great deal of education before it can make policy decisions as part of a joint venture. It may have unrealistic expectations of what the venture can accomplish, and how effectively it can deliver on its obligations to the venture.

Also, a cooperative with major financial or other problems may be seeking any port in the storm. A strong cooperative that enters into an arrangement where control would be shared with a weak one risks being entangled in the weak association's internal difficulties.

• Will the facilities be in an acceptable location? Any plants or other physical assets that will be part of the venture should be located where it makes economic sense both in terms of gathering raw materials and marketing production.

A location may not be ideal for all purposes, but it can still make economic sense. While O-AT-KA's founders had the option of choosing a building site, the other ventures took over facilities in place. This meant potential members had to research whether the location was acceptable rather than the best available. Any problems with location have been met in the normal course of managing the business.

• Will the cooperative have an adequate voice in determining venture policy? All ventures in the study are governed according to the cooperative principle of democratic control. Policy decisions at Hiland, O-AT-KA, and Western are made on the basis of one-member, one-vote. Northland uses limited weighted voting based on patronage.

In reality, virtual unanimity is expected with all four ventures on

policy decisions. Hiland and Western are two-party ventures, so both must agree before an action can be taken. O-AT-KA participants have an open understanding that no decisions will be made until all three members vote alike. Northland has not taken any action unless at least the two larger members were in accord.

There is no legal barrier to the participants in a venture agreeing not to act until more than the required majority of votes, even all votes, are in agreement. Of course, actual practice can be made to conform to the bylaws. Any two participants in O-AT-KA or Northland could simply make decisions over the objection of the third member.

However, this is unlikely. As a joint venture is a limited undertaking, a participant who violently disagrees with a decision of the other participants will probably withdraw from the venture. As this may cripple or destroy the enterprise, the incentive for compromise is strong.

• Can we participate without adversely affecting our other operations? The contribution of a joint venture to a participant could be significantly reduced if relations with other customers and/or suppliers are upset. An important factor in the overall success of Hiland has been Mid-America's ability to convince its other customers that Hiland is not given preference in the pricing and delivery of milk.

Joint Venture Agreement

Once the decision is made to enter into a joint venture, the terms must be finalized and reduced to writing. Retention of legal counsel to make sure the agreement conforms to applicable local, State, and Federal law is strongly recommended. This section of the paper discusses the issues to be covered in the agreement, illustrated by the way these issues are handled in the ventures studied.

• ***Legal structure***. There is no clearly preferable legal structure. O-AT-KA and Northland are organized as corporations, Hiland is a partnership, and Western is simply a contractual agreement.

Ancillary issues can determine legal structure. For example, Mid-America and Prairie Farms organized Hiland as a partnership because

that was the easiest and cheapest way to do it. Roberts Dairy, a similar joint venture between Mid-America and Prairie Farms, was incorporated to take advantage of tax loss carryovers. If the participants wish to insulate themselves from liabilities of the venture, incorporation may provide protection not available in other organizational structures.

• ***Purposes***. The types of services the venture will be authorized to provide should be set out in the organization papers. If the venture is incorporated, State law will require the purposes be listed in the articles of incorporation. Unincorporated ventures should have a statement of purpose near the beginning of the venture agreement.

While the scope of the purpose clauses of the studied ventures varied considerably, from operating a dairy business to anything permissible under State law, all were relatively short and free of the ''legalese'' found in the corresponding article of incorporation of many cooperatives. This is facilitated by the small number of participants in these ventures, which makes amending the purposes clause, if more specificity is needed, relatively simple.

• ***Finance***. The agreement should clearly spell out the financial obligations of each participant and, to the extent possible, how that obligation will be met.

This begins with the initial financing package. For example, the Hiland agreement clearly specified that industrial revenue bonds would be used to acquire the assets from the former owners. The Western Foods agreement spelled out the property and equipment Western General Dairies would contribute, the amount and terms of Mid-America's financial obligation, and the extent of the debt the venture would assume as a separate entity. This ensures all parties understand all obligations before making a final commitment to the venture.

Like many business investments, joint ventures sometimes cost more than the original estimate. Even some of these well-planned ventures required an additional infusion of member capital during the development stage. A cooperative considering a joint venture should make sure all participants are capable of contributing a reasonable amount of additional capital if necessary. But it should also be willing to

terminate the venture if cost overruns significantly diminish the likelihood the venture will succeed in meeting its objectives.

Once these ventures became operational they have generated all the funds required. O-AT-KA and Northland provide for periodic adjustments in the relative capital investments of the members to reflect changes in patronage. Any adjustment in equity of Hiland and Western maintain equality of capital accounts between the participants.

O-AT-KA, which provides a service that generates revenues sporadically, is ensured a steady source of income through the member contributions based on milk in certain pools. This permits both the participants and the venture to plan more effectively than if emergency contributions were required should the venture become temporarily short of funds during a period of low volumes.

The participants must have flexibility in administering such a support plan. While O-AT-KA's bylaws authorize assessments, the board has complete discretion in determining the method of collection, level of contribution, and use of funds.

• ***Distribution of margins***. The agreement should clearly spell out how margins (and losses) will be distributed to participants.

The method of allocation should be consistent with the nature of services provided and received from the venture. O-AT-KA and Northland, which receive product from all participants and provide a manufacturing and marketing service to them, allocate margins and losses on a pure patronage basis reflecting the amount of milk and milk products delivered by the participants. Hiland and Western, which involve one member supplying raw product and the other management and marketing, share margins and losses equally.

• ***Control***. As discussed earlier, in each of these ventures all participants have veto power over any meaningful policy decision. Decisions are reached by negotiated compromise.

It might appear that the most efficient way to decide policy is to have the managers of the participants serve as sole directors of the venture. This would provide a cadre of executives who could run the venture without intruding on the time of their farmer-directors.

In these successful ventures, all of the participants except the smallest member of Northland have multiple seats on the board, and farmer-directors of participants hold some or all board seats.

Farmer involvement strengthens the venture by making sure it provides desired services. It also instills confidence in the producers when they know their elected representatives are determining how those services are provided. The program of Western Foods to make venture board functions accessible to other participant directors and members reinforces this confidence.

Only experienced, capable directors of the cooperatives are selected to serve as farmer-directors of these ventures. In some instances, the farmer-directors are rotated, while in others they sit on the venture's board as long as they hold their seat on the participant's board. The frequency of change among farmer-directors had no identifiable impact on the quality of the venture's board.

• ***Employees***. The participants had a clear understanding of the way the manager and other employees would be selected and how employee problems, including labor relations, would be handled.

As in most businesses, selection of the manager is usually the most important decision the board makes. All participants in a joint venture must have confidence in the manager.

Participants who use authority granted under the organization papers, or voting power on the board, to select a manager over the objection of another participant are endangering the future of the entire venture. As with many key decisions, selection of the manager may require prudent compromise.

The practice of some of the participants to "loan" employees to these ventures, at cost, has simplified locating competent people to solve specific problems and held down overhead expenses.

Also, if the venture is to acquire facilities beyond those already owned by the participants, it would be prudent to consider following the example of the Hiland participants and retaining one or more respected, key employees at that plant. This may help reduce appre-

hension among production employees about the change in ownership and improve the chances of a smooth transition in authority.

• ***Raw materials***. The source and transfer pricing mechanism of raw materials supplied by participants should be clearly spelled out. This may involve different policies for different products and different rights for different participants. There is no clearly preferable method; each studied venture has a system tailored to its participants' needs.

O-AT-KA must bid for participants' milk and is not guaranteed any supply beyond that stipulated in the new marketing contracts.

Northland participants provide whey to the venture without cost and share margins on a patronage basis as their payment.

Western Dairymen has the first option to supply the raw product needs of Western Foods at prices agree to by the participants, but the venture can buy from others sources if Western Dairymen is unable or unwilling to meet its needs.

Mid-America has the right and responsibility to provide all bulk fluid milk to Hiland. The price is determined by the marketing order and any premiums in effect in the region. Either participant may offer to supply other dairy and agricultural products at any price they choose, but the manager may buy these goods from other sources if the price is less than a participant wants.

• ***Marketing***. If marketing is to be handled by the joint venture, then few details are needed in the agreement. The agreements of O-AT-KA and Northland merely mention marketing as a purpose of the venture.

However, if one of the participants performs that function, then the responsibilities and remuneration should be spelled out.

The agreements for Western and Hiland clearly assign the marketing function to Mid-America and Prairie Farms, respectively. Mid-America receives a marketing fee comparable to that of firms providing similar services and Prairie Farms is reimbursed for its out-of-pocket expenditures. The basis for the fee is incidental; the important fact is that the basis for the fee is clearly understood and acceptable to all participants.

In these ventures the manner in which participants divide raw material procurement and marketing responsibilities influences how other operational aspects of the venture are handled. When all participants are providing raw materials and the venture staff is handling marketing, financial commitments are based on patronage and the manager reports to the directors. This is the traditional marketing cooperative organizational mode, reflecting the fact that the participants are supplying measurable units of the same commodity and hiring marketing expertise for common gain.

However, when one participant provides raw product and the other does the marketing, financial commitments are shared equally and the manager reports to the "managing" participant. This sharing of risks and rewards on an equal basis avoids the problem of trying to quantify the value of different types of inputs to the venture.

• ***Nonmember business***. The agreement should cover the extent, if any, of the business the venture may conduct with nonparticipants and the method of handling margins and losses on nonparticipant business.

O-AT-KA and Northland are specifically authorized by their organization papers to conduct business with nonparticipants, provided it does not exceed business with participants. Earnings on nonparticipant business are retained by the venture as earned surplus.

Raw product for Hiland and Western is provided by a participant but may be obtained from outside sources.

The policy of a venture regarding nonparticipant business does not seem to impact on the chances of it succeeding. The important consideration is that participants agree on the role of such activity in the operation of the venture.

• ***Rights to compete***. As all participants are in the same general line of business, and expertise of one participant in the venture's specialty may be the reason that cooperative was asked to participate, competition between participants and the venture is always a possibility.

None of the agreements of the ventures studied specifically limits or

prohibits competition between participants, or between the venture and the participants. If competition is to be restricted, the agreement should carefully spell out how it will be limited. Retention of antitrust counsel is essential if restrictions are to be adopted.

• ***Structural reorganization***. While the studied ventures have operated continuously for some time, the need to restructure or even dissolve the venture in an orderly fashion is always a possibility. Procedures for permitting the withdrawl of a participant and termination are included in the agreements of all four ventures. Three include procedures for admitting a new participant.

Once again, the important consideration is that the participants recognize the possibility of the need to restructure and have agreed how they will accomplish it before the accompanying pressures of restructuring are upon them.

• ***Amendments***. Conditions change, and like any voluntary association, the venture must be able to change also. All agreements may be amended by mutual consent.

While these are important subjects to be covered in the joint venture agreement, many more matters can be covered. Any subject that may lead to friction is best addressed before it becomes an emotional issue. This can range from selection of the auditor to selection of the color scheme for company vehicles.

CONCLUSION

A joint venture among cooperatives is an option available whenever farmers can benefit from a pooling of their cooperatives' resources while limiting individual cooperative investment and risk. It enables farmers, through their cooperatives, to provide needed services for themselves and earn additional margins as well. In the ventures studied, farmers combined raw product supply, manufacturing capability, and marketing skills on a scale large enough to do the job right.

Joint ventures among cooperatives seem particularly appropriate to carry out vertical integration, while maintaining producer control over the expansion. Business activities that may be well suited for joint

venture involvement by cooperatives include value added manufacturing, research and development, distribution, and export marketing.

While a joint venture is usually conceived as a limited operation, it can be the first step to more extensive cooperation among cooperatives. Cooperating Brands, Inc. (CBI) is an example of this growth potential.

CBI began as a simple co-production venture between two cooperatives that produced juice on opposite coasts. It has developed into a nationwide coordinated production, packaging, and marketing operation of five cooperatives headquartered in California, Florida, Washington, and New England.

CBI participants' products retain the brand name identity of the originating cooperative. But the coordinated operation provides buyers single-source access to a full line of single serving, thaw and serve juices. This overcomes a major marketing disadvantage faced by all participants, that noncooperative competitors could provide a variety of juices while each cooperative was limited to offering only products of fruit grown by its members.

This also illustrates that plant economies of scale are only one source of benefits cooperatives can realize through a joint venture. Economies may also develop in procurement, advertising, distribution, finance, R&D, and through diversification.

Finally, a joint venture need not always be initiated as a reaction to a problem. Cooperatives should be alert for opportunities that can be seized through a joint venture with other cooperatives, and be prepared to act when an opportunity arises.

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